No. 14973

United States
COURT OF APPEALS
for the Ninth Circuit

CLARENCE V. WATSON,
Appellant,

vs.

WOODROW C. BUTTON,
Appellee.

APPELLEE'S BRIEF

Appeal from the United States District Court for the District of Oregon.

STANLEY J. MITCHELL,
HARRY A. HARRIS,
Oregon City, Oregon,
Attorneys for Appellant.

DON S. WILLNER,
WM. J. CRAWFORD,
Portland, Oregon,
Attorneys for Appellee.

STEVENS-NESS LAW PUB. CO., PORTLAND, ORE. 4.56

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APPELLEE'S BRIEF

Appeal from the United States District Court for the District of Oregon.

JURISDICTIONAL STATEMENT

The jurisdiction of the United States District Court for the District of Oregon was based upon the fact that plaintiff is a citizen, resident, and inhabitant of the State of Washington and defendant is a citizen, resident, and inhabitant of the State of Oregon, and that the amount in controversy exceeds, exclusive of interest and costs, the sum of $3,000.00. 28 U.S.C. 1332(1); Complaint (R. 3); and Pre-Trial Order (R. 30).

The jurisdiction of this Court is based upon appellant filing and serving a Notice of Appeal and Undertaking for Payment of Costs on Appeal within 30 days from the date of the final decision of the United States District Court for the District of Oregon. 28 U.S.C. 1291, Rule 73, Federal Rules of Civil Procedure, Judgment (R. 51), Notice of Appeal (R. 52), Undertaking for Payment of Costs on Appeal (R. 53).

STATEMENT OF THE CASE

Appellant is here seeking to reverse an equitable judgment against him for misappropriation and fraud. He admits the misappropriation and does not contest the fraud. He admits that he misused his position as president of Highway Freight Inc. to steal $13,945.98. He does not contest the finding that he practiced fraud. Instead, he urges that no one can sue him for misappropriation and that the fraud is not a defense.

Appellant has not seen fit to bring the Transcript of Evidence before this Court.

The Findings of Fact entered by the District Court tell us that appellant Clarence Watson and appellee Woodrow Button were the sole beneficial owners of Highway Freight, Inc., a two-man trucking company (R. 43). Watson was president and general manager (R. 47). On July 20, 1954, Watson and Button sold all the stock of the company (R. 43). Thereafter, Button discovered that during the three years that they owned Highway Freight, Inc. Watson had misappropriated

$13,945.98 (R. 48). This amount was described by the District Court in its Findings of Fact as follows:

"(a) $3,866.25—cash items and checks in records, but not deposited.

(b) $ 403.67—customer's checks not in books.

(c) $2,229.81—non-duplicated deposits in defendant's private bank account.

(d) $1,100.00—deposits in defendant's private bank account after June 15, 1954 for prior hauling.

(e) $ 690.00—California State Board of Equalization performance bond return.

(f) $ 696.66—McCracken receivable.

(g) $ 550.00—Sleeper cab receivables.

(h) $ 327.54—mileage shrinkage of May 6, 1954.

(i) $2,450.96—Diamond T operation expense.

(j) $1,631.09—Kirkpatrick, Scott Lumber and M & M Plywood receivables." (R. 48).

The Court below also found as fact that,

(1) "The purchasers agreed to release and discharge defendant from any claims and demands existing against him in favor of the corporation." (R. 47).

(2) "That the present owners of Highway Freight, Inc., are not entitled to receive the sums listed in Findings VII and VIII above and the present owners of Highway Freight, Inc. have not been damaged by the misappropriation and mismanagement of defendant." (R. 48).

This suit was brought by Button asking for an accounting and judgment for misappropriation, mismanagement, and diversion of corporate opportunity. The court below only enter judgment for misappropriation.

Watson counterclaimed below for judgment on a promissory note given him by Button at the time that

they sold Highway Freight, Inc, and before Button discovered the misappropriations (R. 24, 31, 48). The Court cancelled this note for fraud, finding,

> "That plaintiff signed said promissory note due to the fraudulent misrepresentations of defendant; that at the time plaintiff signed said note he did not have knowledge of defendant's misappropriation and mismanagement; that plaintiff signed said note in reliance on the fraudulent misrepresentations of defendant upon which plaintiff had a right to rely." (R. 49).

Appellant Watson contends that no claim for relief has been stated and that he should have judgment on the promissory note because the fraud found by the Court below is not a defense. Appellee seeks the affirmance of the judgment.

ANSWER TO APPELLANT'S FIRST SPECIFICATION OF ERROR

I. The law gives appellee a remedy for the misappropriations of appellant.

Woodrow Button filed suit below seeking the aid of Equity to recover the money that had been misappropriated and looted by Clarence Watson. The Oregon constitution provides that,

> "Every man shall have a remedy by due course of law for injury done him in his person, property or reputation." (Article I, Section 10, Oregon Constitution).

The Oregon Legislature has enacted Section 1.160 ORS which states that,

> "When jurisdiction is, by the organic law of this state, or by this Code or any other statute, conferred on a court or judicial officer, all the means to carry it into effect are also given; and in the exercise of the jurisdiction, if the course of proceedings be not specifically pointed out by this Code, any suitable process or mode of proceeding may be adopted which may appear most conformable to the spirit of this Code."

This section was clearly construed by the Oregon Supreme Court in the case of *Aiken v. Aiken,* 12 Or. 203, 6 Pac. 682 (1885), where it was stated,

> "It is beyond the scope of legislative wisdom to prescribe a specific remedy for every class of cases that may arise in the complication of human affairs, and it was not attempted; but ample provision was made to prevent a party from being left remediless in case of an infringement upon his legal rights, and the court must of necessity recognize the provision and carry it out when a proper case is presented."

The wrong of misappropriation is admitted by Watson. Button should have a remedy.

II. Appellee's remedy cannot be a shareholder's suit.

It seems clear that since appellee was no longer a shareholder of the corporation when this suit was filed that his remedy could not be a derivative suit. Thus Ballantine On Corporations, Revised Edition (1946), states on page 350,

> "To have standing to bring a derivative suit the plaintiff must be the owner of shares, either of record or as equitable owner, at the time of bringing the suit and during its continuance."

III. Appellee's remedy must be an individual suit.

Watson as president-manager of Highway Freight owed Button a fiduciary duty. As the only other former shareholder of Highway Freight, Inc., Button is the only one damaged by the stealing of Watson. The Court below has found as a fact that the present owners of the Company have not been damaged by the misappropriation and are not entitled to the stolen money (R. 48). Here, the wrong to Button was separate and distinct from the wrong to any other person.

Unless Button in a case like this can recover, the president-manager of a two-man corporation could loot and embezzle at will, secure in the knowledge that the remedies of the other shareholder are ended if the corporation is sold without the looting being discovered. No court of Equity could countenance such a result.

Under Oregon law, an individual suit is allowing against directors who breach their fiduciary duty. The case of *Davis v. Hofer,* 38 Or. 150, 63 Pac. 56 (1901), was a suit for an accounting by a shareholder as an individual against defendants who constituted a majority of the Board of Directors, for corporation money allegedly fradulently misappropriated to the use of defendants. The Court in allowing the accounting stated,

> "The rule is of universal application that a court of equity has jurisdiction to settle an account wherever a fiduciary duty exists between the parties upon whom the duty of keeping account rests . . . [citations] . . . To cite authorities illustrative of the principle that the directors of a corporation are the

> agents of and trustees for the stockholders, who have a quasi reversionary interest in the corporate property after the payment of the corporate debts, seems unnecessary, and the fiduciary relation existing between the parties having been clearly stated in the complaint, jurisdiction of the subject matter attached in equity." (38 Or. 153).

In that case the individual suit was brought by one still a shareholder and the Court had no difficulty finding a cause of suit.

In the case of *Smith v. Bramwell,* 146 Or. 611, 31 P. 2d 647 (1934), cited in appellant's brief on page 8, it is clearly recognized that even in a suit by a present shareholder, relief can be obtained where the damages are "separate and distinct from those resulting to the other shareholders" (146 Or. 620), as they are in our case.

In a suit by a former shareholder, it seems even clearer that an individual suit should be allowed. Thus in the more recent case of *Enyart v. Merrick,* 148 Or. 321, 34 P. 2d 629 (1934), the Oregon Court allowed a former shareholder of a dissolved corporation to bring an individual suit against a former director for an accounting for breach of a fiduciary duty to plaintiff. The director in that case misappropriated pledged stock belonging to the plaintiff. The Court stated,

> "Almost universally, courts of equity treat the relationship of director and stockholder as a trusteeship. Its name or terminology is not material. The law is well-settled that a director is not to be permitted to deal with the corporate stock of other shareholders nor with the assets of the corporation so as to make a profit for himself as distinguished

from his share of dividends in which his fellow shareholders participate." (148 Or. 331).

The *Davis v. Hofer* and *Enyart v. Merrick* cases spell out the fidicuiary duty that Clarence Watson, the president-manager, owed to Woodrow Button, the other shareholder. One of these cases allows an individual suit by a present shareholder, one by a former shareholder. Both recognize that in cases of misappropriation there must be a remedy to the aggrieved party.

The necessity for granting equitable relief in a situation like that presented in the case at bar is best explained in the much cited case of *Hammer v. Werner,* 239 App. Div. 38, 265 N.Y. Supp. 172 (1933). The plaintiff in that case was a former shareholder, as is the plaintiff-appellee here. There as here the plaintiff sought recovery for a breach of fiduciary duty to him. In the New York case, the breach of fiduciary duty consisted of the former directors personally acquiring a block of treasury stock without affording plaintiff an opportunity to participate ratably in the purchase. In that case as in our case, there could be no suit in the name of the corporation against the guilty party or parties. There, because the purchasers of the corporation took with notice of defendant's actions. Hrere, because the purchasers have agreed to release defendant from any claims existing against him in favor of the corporation. In that case as in our case plaintiff acquired knowledge of defendant's breach of fiduciary duty after sale of the stock. The New York Court in upholding the position of the plaintiff stated,

> "The fact that a particular act of directors may constitute a wrong to the corporation which may be righted ordinarily on behalf of the corporation does not bar a stockholder from having redress if that act effects a separate and distinct wrong to him independently of the wrong to the corporation. Redress of this latter wrong is available to him personally despite the right of a present stockholder to redress the wrong in a derivative action so far as it relates to the corporation." (265 N.Y. Supp. 179).

The Court then discusses an earlier New York case which,

> ". . . leaves untouched rights which are personal to the stockholder as a consequence of injuries to his property rights, suffered by him personally at the time he was a stockholder and of which injuries he learns after he has ceased to be a stockholder. Such a chose in action vests in a stockholder apart and distinct from any rights of a derivative character which passes when he conveys the stock. The only chose in action which inheres in the stock and passes when it is conveyed is one that is enforceable exclusively in a derivative action. Plaintiff therefore may maintain this action to redress a wrong to him personally, of the character hereinbefore indicated, while he was a stockholder, although he is not now a stockholder. It is particularly important that such a right may be vindicated, if the wrong was done where no present stockholder exists who can right it, because of the allegation that the present sole stockholder took with knowledge of the wrongful acts of the directors, which wrongful acts for the most part, if not entirely, do not do any damage to the corporation but may be found to have damaged those who were stockholders when the acts of which complaint is made occurred." (265 N.Y. Supp. 179-180).

In our case, the damage was to the plaintiff-appellee who was the only other stockholder with a beneficial interest "when the acts of which the complaint is made occurred."

An Alabama case, *Rochell v. Oates,* 241 Ala. 372, 2 So. 2d 749 (1941), like our case, deals with a suit for an accounting by a former shareholder. There, plaintiff was suing the former directors of a dissolved corporation to compel them to distribute money retained in their hands. In discussing the duty of the directors, the Court stated,

> "As such trustees of a dissolved corporation, they are severally and jointly liable to creditors and stockholders, and may be sued jointly or severally for an accounting as such trustees to all the stockholders, and such a suit may be brought by a single stockholder or shareholder, without bringing into court all other stockholders." (2 So. 2d 751).

Our case is even stronger, because appellant and appellee were the only shareholders with a beneficial interest (R. 47).

The Alabama case was brought by a stockholder against the directors. A similar case in Michigan, *Backus v. Kirsch,* 264 Mich. 73, 249 N.W. 469 (1933), allows a suit against the president of a dissolved corporation by former shareholders for breach of fiduciary duty. In that case as in our case, the defendant president had misappropriated corporation moneys. Plaintiffs there had sold their stock to defendant being unaware that the value of the stock had been lowered due to his misapropriations and they sued to rescind the sale. The Court stated,

> "This is not a stockholders' bill, as plaintiffs are not stockholders, having parted with their shares, and the corporation has been dissolved . . . [citations] . . . The fact that there can be no relief at the instance of stockholders and in behalf of the corporation . . . [citations] . . . does not mean that the wrongs done plaintiff are without remedy." (249 N.W. 470).

The Michigan Court thus stresses the principle that plaintiff should have a remedy when there can be no relief by a corporation suit—there must be a remedy for the wrong.

Likens v. Shaffer, 64 F. Supp. 432 (N.D. Iowa, 1946), cited by appellant on pages 7 and 8 of his brief, involves a suit by *present* shareholders of a corporation whose assets were wrongfully sold by the directors. Our suit was brought by the *former* shareholder who had no standing to right the wrong by bringing a shareholder's suit. The Court of Appeals in *Likens v. Shaffer,* 141 F. 2d 877 (8th Cir., 1944), reversed the District Court and held that plaintiff shareholders may have avoided the Statute of Limitations by making out a breach of fiduciary duty resulting in a constructive trust. The opinion cannot be read without gaining the impression that the Court is clearly saying that Equity will find a way to grant relief in a fact situation like the one there presented. (This controversy is also reported at 40 F. Supp. 729, 50 F. Supp. 103, 64 F. Supp. 432, and 323 U.S. 756.)

But even if the corporation could sue—it could not in our case—plaintiffs have been given a remedy for individual wrongs to them. In the New York case of

Blakeslee v. Sottile, 118 Misc. Rep. 513, 194 N.Y. Supp. 752 (1922), the plaintiff shareholder sued the active manager of the corporation who was the trustee of plaintiff's shares for diverting a corporate opportunity, the expiring Cadillac dealership, to another corporation which he had formed. The Court stated:

> "I see no difficulty in the application of the rule that, where the wrongful acts are not only wrongs against the corporation, but are also violations by the wrongdoer of a duty arising from contract or other obligation, and owing directly by him to the shareholders, that an individual action may be maintained, regardless of the fact of a corporate right to maintain an action for relief in its behalf." (192 N.Y. Supp. 752).

When the damage is to the individual plaintiff, as it is in our case, the Equity Court will provide a remedy. In the Pennsylvania case of *Porter v. Healy,* 244 Pa. 427, 91 Atl. 428 (1914), the plaintiffs were former shareholders suing former directors for an accounting of an illicit gain occurring when the defendants received more money proportionately for selling their interest in the corporation than the other shareholders did. The Atlantic Reporter head note sums up the case this way,

> "That a stockholder has parted with his stock does not deprive him of his right to sue in equity for an accounting, directors who unlawfully take advantage of their position to his detriment."

IV. By giving appellee a remedy for the wrong no one is hurt except the wrongdoer.

Appellant in discussing the misappropriations in his brief states, "we admit as true the Findings of Fact of

the Court." (Appellant's Brief, p. 3). He fully admits that he stole $13,945.98 but then argues that Button is not the right person to sue him for its return. If the doctrine of unclean hands is to mean anything it should apply in this case. Watson has no claim for relief at the hands of a Court of Equity. His only concern is that he not be sued twice for his theft.

There can be no suit against Watson by Highway Freight, Inc. The parties have stipulated in their Pre-Trial Order that the purchasers of Highway Freight, Inc. have agreed to release and discharge Watson from any claims and demands existing against him in favor of the corporation (R. 31). This has also been found as a fact in the findings of the District Court(R. 47).

The primary right of suit against a wrongdoer is in the party wronged. Creditors have no direct right of suit against a former president of a corporation. Ballantine on Corporations, Revised Edition (1946), p. 186. Creditors, under certain circumstances, are able to bring a derivative suit in the name of the corporation. But since the corporation has waived its rights to sue Watson the creditors have no cause of suit against him either, because their rights can be no higher than the rights of the corporation. There can be no duplicity of action against Watson.

Appellant on pages 9 and 10 raises the question of the correctness of the Findings of Fact of the court below dealing with the amount of the judgment that was entered for appellee. If appellant wishes to question whether $13,945.98 is the proper figure rather than

some percentage thereof he could have included this as a specification of error and brought here the Transcript of Evidence.

> "The evidence on which the findings are based is not in the record. Therefore, we must and do accept the findings as correct." *Bernard v. Johnson,* 103 F. 2d 567, 571 (9th Cir., 1931).

Union Pacific RR v. Bridal Veil Lumber, 219 F. 2d 825 (9th Cir., 1955); *Tozzi v. Balley,* 148 F. 2d 660 (9th Cir., 1945); *Rickard v. Thompson,* 72 F. 2d 807 (9th Cir., 1934); and *Bank of Eureka v. Partington,* 91 F. 2d 587 (9th Cir., 1937), have the same holding.

If appellee's judgment for misappropriation be sustained, no one is hurt except the confessed misappropriator, appellant herein.

ANSWER TO APPELLANT'S SECOND ASSIGNMENT OF ERROR

The District Court has made the following Finding of Fact:

> "That on or about July 20, 1954, plaintiff made, executed and delivered to defendant his promissory note in the amount of $3,000.00; that plaintiff signed said promissory note due to the fraudulent misrepresentations of defendant; that at the time plaintiff signed said note he did not have knowledge of defendant's misappropriation and mismanagement; that plaintiff signed said note in reliance on the fraudulent misrepresentations of the defendant upon which plaintiff had a right to rely." (R. 49).

Appellant argues in his brief, pages 10-12, that the evidence does not support this Finding of Fact and that

fraud is not a defense to the note. Instead of bringing up the Transcript of Evidence, appellant inserts in the Transcript of Record six questions and answers which were part of his cross-examination. This is like an appellant from a murder conviction including in the record only his answer to the question put to him by defense counsel whether he shot the victim.

The Court below heard all the evidence and arrived at the above Finding of Fact. Since the evidence is not before us we are not able to argue whether the Diamond T truck should have been originally included in the assets of Highway Freight, Inc. that were sold to the purchasers and whether there is evidence that appellee was damaged in the amount of $3,000.00 by being fraudulently induced to sign this promissory note in effect repurchasing the truck for the purchasers. All that we can say is that where appellant does not bring up all the evidence this Court has repeatedly held that the Finding of Fact will be accepted as correct. *Bernard v. Johnson,* supra; *Union Pacific RR v. Bridal Veil Lumber,* supra; *Tozzi v. Bailey,* supra; *Rickard v. Thompson* supra; *Bank of Eureka v. Partington,* supra (all decisions of this Court). Since every element of fraud was made out, the Court below made the only possible Conclusion of Law in cancelling the note for fraud.

CONCLUSION

For the reasons above stated the judgment of the United States District Court for the District of Oregon should be affirmed.

Respectfully submitted,

DON S. WILLNER,
WM. J. CRAWFORD,
Attorneys for Appellee.